Economic Outlook

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Economic activity probably slowed in August, most likely because of the heat and drought rather than the effects of tighter monetary policy. At current levels, interest rates are unlikely to exert enough restraining influence to bring economic growth down to the 2.0-2.5% range that the Federal Reserve believes is compatible with less inflation. Tighter monetary policy does appear, however, to have reduced optimism about the growth outlook according to the Federal Reserve's latest survey of economic conditions. Nevertheless, a careful look at recent statistics indicates scant evidence for a sustained slowdown from the 3.3% pace of the first half. The combination of strong statistics in June and July and one of the hottest summers in recent memory make the August statistics look weaker than the economy's underlying growth trend. Production should bounce back from the August doldrums as the effects of hot weather and the drought recede into history. Until evidence of economic strength re-emerges, reduced fears of Fed tightening should bolster business confidence and pave the way for additional output gains.

The employment report for August caused a sharp shift in sentiment, hinting to some analysts that a major cooling off may have begun. Payroll employment was up by 219,000, about as expected, but as has so often been the case, the market shaking news was in other parts of the report. Most notably, there was a sharp fall in the average work week. At least part of the drop is a result of the hot weather and attendant adverse working conditions. There were scattered reports of workers walking out of plants because of severe heat. It also seems reasonable that outdoor work was curtailed in the scorching August weather to avoid physical harm to workers. In addition, the drought had a negative impact on seasonal vegetable harvesting and food processing employment, especially in the Midwest.

The financial markets also took comfort from a sharp downward revision to the July payroll employment increase which was reduced from 283,000 to 200,000. Two factors seem to explain most of this adjustment. First, about 30,000 new jobs were added to the revised June payroll figure, thus reducing the July increase. Second, the revision to the July number was largely due to a reduction in local government employment. Neither of these factors are convincing evidence of a slowdown in the private sector. One indisputable piece of good news on the inflation front was the slight rise in the index of average hourly earnings. But again this is one month's number following some large increases. With initial claims for unemployment insurance remaining quite low and consumer confidence quite high, it seems premature to write off the possibility of building wage inflation.

While the latest Federal Reserve survey of regional conditions found less optimism about the outlook, it still found the pace of business activity through late August relatively unchanged from earlier surveys, with weakening conditions noted only in the St. Louis district. The softness in the midwest economy clearly reflects the adverse summer weather conditions with employment declines particularly severe in the mining, construction, and food processing industries. In contrast, "many chemicals producers, saw mills, and paper manufacturers, are running at maximum capacity due to a rapid increase in exports and strong domestic sales." Overall the Tan book suggests little

change in economic conditions from earlier this year and it supports the idea that new signs of weakness are largely weather-related. As a result, the lagging St. Louis district is likely to show a rebound in the next few months.

Inflation remains a concern throughout the country. The Fed report summarizes the price situation as follows: "Rising raw materials costs continue widespread, and higher prices for components are increasingly being noted. Further price increases are expected." The purchasing manager's report also found price pressures to continue in August but at a slightly lower pace than in earlier months. In particular, "price increases in metals appear to be abating but drought related increases seem to be taking their place." Overall, the purchasing manager's index slipped to 56.2% in August from 59.0% in July. Coming on the heels of the weak August employment report, this was taken as additional evidence that the economy was slowing. However, the index remains at a level that has been consistent with 3.7% growth in the past, a growth rate that is substantially above the Federal Reserve's estimate of what is consistent with non-inflationary growth.

Excluding the farm sector, real output expanded at a robust 4.7% rate in the second quarter. Drought related losses will continue to reduce output growth over the next few months. While the statistics for August may herald a more sustained slowdown in U.S. economic growth, it seems premature to draw such a conclusion until the ripple effects of the drought have passed through the economy.

Robert. T. McGee

Real GNP

(Percent Contribution to Real GNP Growth; Annual Rates)	Actual				Forecast				Actual	Forecast	
	1987		1988		1988		1989		1986-	1987-	1988-
	III	IV	I	II	III	IV	I	II	1987	1988	1989
Consumer Spending	3.0	-1.4	2.9	1.8	1.3	1.2	1.1	0.8	1.8	1.6	1.1
Business Investment	3.0	0.2	0.9	1.8	1.3	1.2	1.1	1.0	0.3	1.4	1.1
Residential Investment	-0.6	0.0	-0.3	0.1	-0.1	-0.2	-0.2	-0.2	0.0	-0.2	-0.2
Change in Inventories*	-1.0	6.3	-2.0	-2.8	0.2	0.2	0.1	0.2	0.2	-0.1	0.0
Net Exports	-0.5	0.5	1.7	1.9	0.7	0.6	0.6	0.6	0.2	1.0	0.7
Government Purchase*	0.6	0.5	0.2	0.5	0.3	0.3	0.3	0.3	0.9	0.5	0.3
Real GNP	4.5	6.1	3.4	3.3	3.7	3.3	3.0	2.7	3.4	4.2	3.0

Quarterly Economic Indicators

(Percent Changes at Annual Rates)	Actual				Forecast				Actual	Forecast	
	1987		1988		1988		1989		1986-	1987-	1988-
	III	IV	I	II	III	IV	I	II	1987	1988	1989
Nominal GNP	7.7	8.6	5.4	8.3	8.6	8.5	8.6	8.8	6.8	7.6	8.6
GNP Deflator	3.1	2.4	1.7	5.1	4.6	5.0	5.4	5.9	3.3	3.3	5.5
Corporate Profits After Tax#	12.7	5.7	10.3	18.1	9.6	8.9	7.5	5.8	10.2	11.7	6.4

Monthly Economic Indicators

	Recent Data			Actual	Forecast	
	June	July	Aug.	1987	1988	1989
Consumer Price Index** (%)	0.3	0.4	n.a.	4.4	4.8	6.3
Industrial Production (%)	0.4	0.8	n.a.	3.7	5.2	3.0
Retail Sales (%)	0.4	0.5	n.a.	5.1	5.4	5.2
Auto Sales (million units, a.r.)	11.0	10.7	10.6	10.3	10.3	9.3
Housing Starts (million units, a.r.)	1.45	1.49	n.a.	1.63	1.45	1.35
Unemployment Rate (%)	5.3	5.4	5.6	6.2	5.4	5.2
Merchandise Trade Balance ($ bn., a.r.)	-150.5	n.a.	n.a.	-171.2	-145.0	-125.0

*Adjusted for CCC purchases. **Annual percent changes are December to December.

#Quarterly data are year-over-year percent changes.

a.r. = annual rate